No. 10087

In the United States Circuit Court of Appeals for the Ninth Circuit

MINNIE L. WHITTHORNE AND EVA WHITTHORNE, EXECUTRICES OF THE ESTATE OF W. R. WHITTHORNE, DECEASED, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

and

SHERWOOD SWAN, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISIONS OF THE UNITED STATES BOARD OF TAX APPEALS

SUPPLEMENTAL BRIEF FOR THE RESPONDENT

SAMUEL O. CLARK, Jr.,
Assistant Attorney General.

SEWALL KEY,
MURIEL S. PAUL,
Special Assistants to the Attorney General.

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The Board of Tax Appeals held that the taxpayers' settlement of their debts to the Bank of America and to the Central National Bank of Oakland came within the rule of *United States* v. *Kirby Lumber Co.*, 284 U. S. 1, the purport of which is that a solvent corporation which purchases its own obligations for less than their face amount realizes taxable income in the amount of that difference.

Subsequent to the filing of briefs upon taxpayers' appeal to this Court, the Supreme Court on March 1, 1943, rendered its decision in *Helvering* v. *Amer. Dental Co.,* 318 U. S. 322. Thereafter, and on April 13, 1943, the taxpayers filed a supplemental memorandum in this Court wherein it is contended that the decision in the *Amer. Dental* case is determinative of the instant case and that no taxable income was realized through the settlement of taxpayers' indebtedness. In that case the taxpayer owed past due bills for merchandise. The indebtedness was represented by interest-bearing notes. The creditor agreed to cancel the accrued interest. The taxpayer also owed back rent and its landlord accepted approximately one-half of the amount due in full payment. The Supreme Court held that the amounts cancelled by its creditors constituted gifts to the taxpayer.

It is the Government's position that the facts do not bring this case within the doctrine of the *Amer. Dental* case and that it is governed by the *Kirby Lumber* case as set out in our original brief (pp. 10–20). At the outset we emphasize two things. One, that the Supreme Court did not overrule its decision in the *Kirby Lumber* case, and, two, that the present taxpayers' indebtedness is not of the type dealt with in the *Amer. Dental* case. In the latter, the Court dealt only with the particular indebtedness cancelled in that case and, in effect, differentiated it from other types of debt cancellation. Specifically it said (pp. 327–328):

> In fields closely related to the cancellation of indebtedness which we are considering here, this Court has treated gains in net assets as

> income. In *United States* v. *Kirby Lumber Co.*, 284 U. S. 1, the taxpayer purchased its own bonds at a discount. It was held taxable on the increase in net assets which resulted. * * * Forfeiture or surrender of a lease by which the lessor gains property or money makes such gain taxable. *Helvering* v. *Bruun,* 309 U. S. 461; * * *.

The Court continued to illustrate the various types of debt reductions by referring to the "narrow line" between taxable bonuses and tax free gifts. *Bogardus* v. *Commissioner,* 302 U. S. 34; *Noel* v. *Parrott,* 15 F. 2d 669 (C. C. A. 4th), as approved in *Old Colony Trust Co.* v. *Commissioner,* 279 U. S. 716, 730. It pointed out that where the indebtedness has represented the purchase price of property, a partial forgiveness has been treated as a readjustment of the contract rather than a gain. (*Hirsch* v. *Commissioner,* 115 F. 2d 656 (C. C. A. 7th); *Helvering* v. *A. L. Killian Co.,* 128 F. 2d 433 (C. C. A. 8th)) and that where a stockholder gratuitously forgives the corporation's debt to himself, the transaction has long been recognized by the Treasury as a contribution to the capital of the corporation.

The Court concluded that the voluntary act of the creditors in releasing part of the rent arrears and the interest on notes given for merchandise claims (p. 330)—

> is more akin to a reduction of sales price than to financial betterment through the purchase by a debtor of its bonds in an arm's-length transaction.

It is submitted that there is no language in the Supreme Court's opinion which justifies the conclusion that a release of note indebtedness representing borrowed funds is "akin to a reduction of sale price." On the contrary it is more akin "to financial betterment through the purchase by a debtor of its bonds in an arm's-length transaction", and is clearly within the doctrine of *United States* v. *Kirby Lumber Co., supra.*

In the *Amer. Dental* case, the Court concluded (p. 331) that the forgiveness of the rent and merchandise claims "was gratuitous, a release of something to the debtor for nothing," and sufficient to make the cancellation there gifts within the statute. While a simple release by a landlord of past due rent and the release by a merchant of his claims for merchandise sold may be purely gratuitous and voluntary, it is difficult to see how the release in the present case could be called gratuitous.

In summary, the situation here is that the taxpayers jointly owed the Central Bank $165,081.32 and Swan separately owed that bank $20,000. Those notes were secured by 500 shares of Sherwood Swan & Company, Ltd.; 2,000 shares of Swan's (another corporation); 1,725 shares of Wasserman-Gattmann Company; and an insurance policy on the life of Swan. (R. 80.)

They jointly were indebted to the Bank of America in the principal amount of $89,066.33, and Swan was separately indebted in the principal amount of $65,000. These notes were secured by 500 shares of Sherwood Swan & Company, Ltd., 2,071 shares of Hale Brothers

Realty Company, 2,000 shares of Swan's (another corporation), and 1,725 shares of Wasserman-Gattman Company. (R. 80.)

In order to pay a portion of their obligations to the two banks the taxpayers were obliged to refinance their company.[1] A third bank, the Anglo-California Bank, agreed to advance $175,000 on condition that it obtain the 1,000 shares of Sherwood Swan common stock as collateral. (R. 80–81.) The taxpayers were then to issue new stock in exchange for the old common. The arrangement also encompassed the agreement of an underwriting firm to purchase $175,000 worth of the new stock and to furnish collateral to the Anglo-American Bank for the shares so contracted for. (R. 81–82.) The bank was to release the remaining shares of new stock to the taxpayers when the underwriter completed payment of the purchase price ($175,000) of the shares sold to it. (R. 83.)

On the day that the taxpayers obtained the loan of $175,000 from the Anglo-American Bank, $75,000 was turned over to the receivers of the Central Bank, together with the taxpayers' joint note for $20,000. The 500 shares of Sherwood Swan stock were then released to the Anglo-American Bank, the transaction being approved by the court. (R. 79–80.) The following day $100,000 was turned over to the Bank of

[1] The vice-president of the Central Bank testified (R. 120) that he recalled numerous discussions urging Swan to endeavor to finance the market in order to pay on that bank's indebtedness. These discussions apparently occurred as far back as 1930 to 1933. (R. 119.)

America together with Hale Brothers Realty Company stock worth $34,564.69.[2]

It seems wholly unreasonable to contend that this transaction, which involved not only the taxpayers and the two creditor banks but also the Anglo-American Bank and an underwriting firm, was not an "arm's-length transaction." The settlement of the notes was interdependent with the other steps in the entire arrangement. The banks' surrender of taxpayers' notes for less than their face value has no element of gratuity. The plain fact is that the Central Bank's receiver and the Bank of America bargained for the best payment obtainable. Furthermore, the Bank of American received outright certain stock worth $34,564.69 which it had theretofore held as collateral and the Central Bank received a joint note of $20,000 in place of Swan's separate note for that amount.

We submit that this constituted consideration for the amounts of debt cancelled, even in a technical sense, but in any event it is sufficient to distinguish the transaction from the purely gratuitous and voluntary release of the past due obligations involved in the *Amer. Dental* case, *supra*. Certainly it would be a strange assumption that the banks owing a fiduciary duty to their depositors, had either motive or intent to confer a gift of their funds upon the taxpayers,

[2] This settlement was handled by means of a sale at which the taxpayers bid in the 500 shares of Sherwood Swan stock for $100,000 and the bank bid in the other securities, pledged with it, at $96,073.14. The entire worth of the latter was $34,564.69. (R. 80.)

particularly in the case of the Central Bank whose settlement was approved by the District Court.

As stated above, the Supreme Court did not discard the principle established by its former decisions, that the retirement of a corporate loan obligation by payment of less than the amount borrowed results in the realization of taxable income. The present obligations were no different, in substance and from the tax viewpoint, from the obligations which were cancelled in the *Kirby Lumber* case, *supra,* and decisions following it. It is clear that unless the doctrine of the *Kirby Lumber* case and the applicable regulations are reduced to a nullity, the gain realized by taxpayers here cannot be considered a tax exempt gift. We submit that the decision in the *Amer. Dental* case does not affect the contentions made in our original brief as to the applicability of the *Kirby Lumber* case and that for reasons previously advanced in that brief the taxpayers realized income in the amount determined by the Board.

CONCLUSION

The Board of Tax Appeals' decision should be affirmed as to all issues for the reasons presented in our original brief.

Respectfully submitted,

SAMUEL O. CLARK, JR.,
Assistant Attorney General.
SEWALL KEY,
MURIEL S. PAUL,
Special Assistants to the Attorney General.

AUGUST, 1944.

U. S. GOVERNMENT PRINTING OFFICE: 1944